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SUBJECT: MESOPOTAMIA SEED AND IRAQ'S PRIVATIZATION CONUNDRUM

Classified By: Charge d'Affaires David M. Satterfield for reasons 1.4 (

b) and (d).

¶1. (C) SUMMARY: Iraq's Mesopotamia State Company for Seeds (MESO) exemplifies the GOI's main challenges in privatizing its state-owned enterprises (SOEs). MESO employs a large number of unskilled workers who would be displaced by any privatization effort; it heavily relies on subsidized inputs; and it possesses poor facilities infrastructure. MESO management supports gradual privatization via "rehabilitation." Embassy representatives told their management that Iraq needs an effective privatization law before undertaking privatization efforts (including "rehabilitation") and that strong intellectual property rights (IPR) protections are necessary to encourage investment in Iraq's seed sector. We are encouraging the GOI to create such laws, identify SOEs suitable for privatization, and develop a strategy for protecting workers.

In addition, we will suggest to the Minister of Agriculture that he make land reform and the privatization of seed distribution strategic priorities. END SUMMARY.

Unintended Consequences

¶2. (C) MESO is a Ministry of Agriculture SOE that sells mainly wheat, barley, maize, clover, and pulse seeds to Iraqi farmers at subsidized prices. Dr. Aziz Shamkhi Jabur, Director General of MESO, told us June 20 that he supports privatizing MESO "step-by-step." Aziz told us that his main concern about privatization is the large number of MESO workers who would be displaced. According to Aziz, MESO currently employs 450 people at its 19 factories, but it only needs 150 employees -- a system he termed "masked unemployment." Aziz told us that MESO employs 85 agronomists and 80 engineers, with most of the remaining employees having few skills that could be taken into the private marketplace.

¶3. (C) The displacement of SOE workers is likely the greatest privatization challenge that the GOI faces. USAID's Private Sector Growth and Employment Generation Program (Izdihar) estimates that Iraq's SOEs employ 600,000 people, or approximately 9 percent of Iraq's workforce. Under a successful privatization initiative, Izdihar estimates that the GOI would displace approximately 360,000 of its SOE employees. The GOI's current policy of ramping up SOE hiring (at least 70,000 so far this year), while in some minds alleviating unemployment tensions, may also serve to swell the numbers of displaced workers under privatization, or even add to hesitations about privatization.

Rehabilitation at the
Expense of Privatization

¶4. (C) Director Aziz claimed that the poor condition of MESO's facilities also would hinder privatization. The SOE currently requires \$12 million for annual repairs and maintenance, he said, and then asked, "Who would be willing to invest in such a company?" (NOTE: According to a January 2004 study by USAID's Agriculture Reconstruction and Development Program for Iraq (the most recent available), MESO's 2002 revenues were just over \$33 million. However, we do not have an accurate accounting of MESO's operating costs, nor do we have historical information on the SOE's performance, so it is hard to determine the ramifications of \$12 million in annual maintenance and repair outlays. END NOTE.) Director Aziz told us that the best way to privatize MESO is to first "rehabilitate" its 19 factories to a condition that foreign investors might be willing to accept. Only then, he predicted, could the factories be sold to create competition gradually against MESO's remaining state-owned factories.

¶5. (C) Director Aziz's comments mirror those of other GOI officials who view "rehabilitation," or the rebuilding of Iraq's SOE infrastructure, as a necessary first step before privatization. Many of these officials, however, also envision the state maintaining a significant share of ownership as part of any privatization outcome. We have made clear to these officials our opinion that this is a distorted view of privatization. GOI officials who support "rehabilitation" are likely using it as a delaying tactic against privatization. It is highly possible that these officials would rather maintain ownership of "rehabilitated" profitable SOEs -- using them as revenue generators for political or personal purposes -- than sell them to private sector investors, after which the long-term cash flows would disappear.

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Subsidy Reliance

¶6. (C) According to Director Aziz, another hindrance to privatizing MESO is that Iraqi farmers likely will resist paying unsubsidized seed prices. As an example, he explained that MESO typically pays about \$500 per metric ton of wheat seed, mostly to Turkish suppliers, which it then sells to Iraqi farmers for about \$300 per metric ton. The Ministry of Agriculture makes up the difference. (NOTE: Prices paid to foreign suppliers and charged to Iraqi farmers vary depending on the quality of the seed. END NOTE.) MESO also relies heavily on subsidized fuel and electricity prices. This heavy reliance on subsidies is typical of Iraq's SOEs. Without discounted inputs and, in many cases, a guaranteed market of SOE buyers, most of Iraq's SOEs could not operate profitably.

¶7. (C) The average Iraqi farmer, besides being "addicted" to subsidies after decades of entitlement, is probably hard-pressed to afford unsubsidized seed prices. Many Iraqi wheat farms do not have a high productivity per unit of land compared with neighboring countries' wheat production. Iraqi wheat production per hectare averages about one metric ton; neighboring countries produce over twice as much per hectare.

This low productivity, together with Iraq's smaller-scale wheat farming operations, makes it difficult for Iraqi wheat farmers to enjoy profitable enterprises. Even at the current price of \$305 per metric ton paid by the Ministry of Trade for high-grade wheat (which is 53 percent higher than the average international freight-on-board market price), many Iraqi wheat farmers might be having difficulty achieving profitability.

Land Reform and Seed Vouchers?

18. (C) Embassy believes that if the MoA were to institute effective policies to alleviate farmers' productivity problems, it could result in an easier privatization process for seed distribution. For example, under current Iraqi law, the vast majority of farmers lease their land from the government and are unable to contract with other farmers to buy or sell land. If the GOI were to reform land ownership laws so farmers could buy or sell, Iraqi farmers could consolidate land holdings and improve their chances of profitability. Over time, farmers could afford to pay higher prices for seed, and if private-sector distributors were encouraged to enter Iraq's market, farmers could procure a wider variety of seeds than what is currently offered by the MoA. Paralleling the voucher program already in existence in the fuel-supply sector, the MoA could even develop a "seed voucher" system. Farmers would use the vouchers to procure seed. By honoring these vouchers at both private-sector distributors and its SOEs, the MoA could encourage private-sector growth and at the same time prepare MESO and the other seed-distribution SOEs for privatization. This type of program could also make Iraq's agriculture sector more efficient by giving farmers a greater variety of seed and services to choose from and, as a result, a chance to make better use of their available natural resources of land, water, and climate.

A Transparent Government Exit

19. (C) MESO exemplifies the problem with privatization in Iraq. We explained to Director Aziz that the GOI first needs to pass a law that ensures fair and transparent privatization, including the creation of an independent agency to oversee the process. (NOTE: Up to now, the GOI has not pushed privatization legislation aggressively, but it has been seeking foreign investors to help rebuild its SOE infrastructure. END NOTE.) We also explained that a necessary complement to a privatization law would be the creation and enforcement of effective intellectual property rights (IPR) laws to enhance the potential for investment in Iraq's seed sector; foreign seed companies will not invest in Iraq if the GOI does not actively enforce IPR protections. At the same time, it is necessary for the GOI to start determining which of its approximately 192 SOEs potentially could thrive under private management. Without such a prioritized list, the privatization process would probably be inefficient.

The Labor Dimension

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110. (C) Post also believes that the GOI must develop a strategy to deal with the ramifications of full privatization on the labor market. One potential solution could be to expand Iraq's new Social Safety Net program administered by the Ministry of Labor and Social Affairs. However, monetary benefits under the current program typically would be about one-third of an SOE employee's current income. It is possible that Iraq's new pension law also could help alleviate the dilemma of displaced SOE workers, pulling those of retirement age out of the labor pool. However, this option in its current form promises to be a serious drag on the GOI budget. Yet another solution, as developed by USAID's Izdihar, is to offer payout packages to SOE employees based on salary grade and the income that would have been earned between the time of resignation and the time when the employee would have faced compulsory retirement. This too has large budgetary costs that are currently unsustainable. The long-term solution to the displacement of SOE workers

under privatization is jobs generated by private-sector development. We will encourage the GOI to take the necessary steps to protect the displaced workers of privatization, especially by encouraging private-sector growth initiatives.

SATTERFIELD